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The August 2008 Conflict: Economic Consequences for Russia

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Russia's intervention in Georgia in August 2008 has economic consequences. Some are short-term only; some are likely to be perceptible only in the longer term. In both cases, some effects are beneficial to Russia, and some are harmful.

The likely consequences are easy to list but impossible to measure. There are more negative effects than favourable ones for Russia. That is no guarantee that, in total, the damaging effects will outweigh the positive effects. All the listing can do is provide an agenda for future monitoring, and perhaps some guidance for policy.

One final caveat: several Russian economic indicators – growth, the stock market index and net international capital flows, for example – were already deteriorating before the conflict. Evidence about any negative economic development for Russia after mid-August needs to be interrogated with this in mind. Was that development already visible before 7 August? If it was, do we really have any indication that it was exacerbated by the conflict?

Short-term positive effects for Russia

Azerbaijan diverted some crude oil deliveries from the Baku–Tbilisi–Ceyhan (BTC) pipeline to the Caspian Pipeline Consortium (CPC) Baku–Novorossiisk line. One estimate, by a Deutsche Bank economist in Moscow, was that a switch generally from BTC to CPC would be worth $1.3 million a month to Russia (in transit fees) – trivially small in relation to Russian GDP.

Capital flight, which also has negative connotations, occurred in the period 8–22 August. The reserves fell by $16 billion. This reduced the money supply and eased inflationary pressure.

Negative Short-Term Effects for Russia

The war entailed direct military costs in fuel, ammunition, etc.

The city of Moscow allocated R2.5bn ($100m) from its budget to the restoration of Tskhinvali. (Three-fifths of South Ossetia's budget revenue already comes from the Russian federal budget via North Ossetia.)

The Minister for Emergency Situations Sergei Shoigu funded the replacement of two mobile phone masts in South Ossetia.

Capital flight, by restricting the money supply, tended to push up interest rates, with some (probably small) negative effect on investment – the obverse of the positive effect noted above. Standard & Poor's estimates the net outflow of capital from Russia in August at 1% of GDP and expects the same for September.

The stock market fell. It has mostly been falling this year (both RTS and MICEX indexes), so the Georgian conflict merely strengthened an existing tendency.

Long-term positive effects for Russia

The show of force against Georgia will probably enable Moscow to extract better terms in negotiations (e.g., over gas prices) with other neighbours.

The fighting and subsequent Russian occupation raise doubts in the West, Azerbaijan, and Kazakhstan about the future viability of pipelines running through Georgia. This should assist Russia's market power in Europe, exercised through its predominant control over pipelines. (But note that Azerbaijan confirmed its support for the Nabucco pipeline on 1 September.)

Negative long-term effects for Russia

Potential foreign lenders and inward investors into Russia see heightened political risk in Russia and are correspondingly less likely to lend or invest. How large and how prolonged that effect will be is an open question. A Deutsche Bank analyst put forward a 'worst–case' scenario: a fall of 30–40% in inward foreign investment, which he estimates would knock 0.4 to 0.5% off GDP. Foreign firms already well established in Russia may be somewhat differently affected: their top managers will probably be happy to continue business as usual, but shareholders' worries might constrain them. (One example of apparent continuity is that ConocoPhillips has proceeded with the development with Lukoil of the Yuzhno-Khyl'chuyunsk oil field, and is looking at other developments with Lukoil, including in Iraq.)

Even doveish EU member-states may be moved to reduce their dependence on Russian energy supplies. The German Economy Minister, Michael Glos, said on 29 August that events in the Caucasus required a reduction of dependence on Russia, and the German government was considering the development of a national strategic gas reserve.

The delay in or suspension of Russia's negotiations for accession to the World Trade Organization (WTO), though treated lightly by Putin and probably welcomed by many in Russia, is not in Russia's long-term economic interest. Moscow's moves to block imports of chicken from the US (about 30% of Russian consumption of chicken) will push up prices. Representatives of the Russian poultry industry say it would take 4–5 years to develop domestic production to replace imports.

Russia will lose revenue from the suspension of the US–Russia cooperation agreement on civil nuclear matters (Russian disposal of US nuclear waste).

Russia may well have to spend more on security in the North Caucasus. Also, the official military budget has been rising at 23–24% a year lately in nominal terms. Reportedly, inflation in military items is so rapid that this means stagnation in real terms. Some acceleration of that spending – at the expense of either other budget headings or the battle against inflation – is likely.

The collapse of Russian stock-markets in the week starting 15 September 2008 cannot be attributed to the Georgian conflict. It was far less significant than the general, worldwide loss of confidence on financial markets and – particularly affecting Russia – the decline in the oil price. The conflict, in other words, was a minor, exacerbating influence on a financial meltdown that would almost certainly have occurred even in its absence. The collapse in Russian share values and the injection of budget funds to prop up the market will have taken the edge off a sense of triumphalism following the conflict in Georgia. On the other hand, it is a breakdown associated with markets and global influences. It is therefore the politically and economically liberal policy-makers in the present political elite who are most likely to be blamed for it. If anything, it may tend to strengthen those politicians who adopt an isolationist, anti-Western stance.

Some of the effects listed above are small or negligible. The potentially significant effects at present defy measurement. *Best guess*: long-run net negative effect, superimposed on other factors slowing Russian growth.

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